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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

In re MOSES N. ASLAN,
Debtor.

MOSES N. ASLAN,
Petitioner,
vs.
THE HONGKONG AND SHANGHAI BANKING CORPORATION AND CENTRAL BANK,
Respondents.

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

ILLYSSA I. FOGEL
Counsel of Record
and
ANN VAN BEVER
PULLIAM, GRAVES & FOGEL
555 South Flower Street, 28th Floor
Los Angeles, California 90071
(213) 489-4777

Attorneys for Petitioner
MOSES N. ASLAN

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QUESTIONS PRESENTED FOR REVIEW

1) Did the Ninth Circuit Court of Appeals err in affirming the Bankruptcy Court's failure to look behind a stipulated state court judgment to determine the validity of a creditor's claim against the bankruptcy estate?

2) Did the Bankruptcy Court err in failing to disallow the $2 million penalty portion of a creditor's claim?

PARTIES TO THE PROCEEDING

Petitioner and Respondents are named in the caption and were also parties before the Ninth Circuit Court of Appeals.

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No. _____

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1992

In re Moses N. Aslan,
Debtor.

MOSES N. ASLAN,
Petitioner,

vs.

THE HONGKONG AND SHANGHAI BANKING CORPORATION
and CENTRAL BANK,
Respondents.

PETITION FOR WRIT OF CERTIORARI

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Moses N. Aslan respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on May 29, 1992.

REPORTS OF OPINIONS BELOW

The Memorandum Opinion of the Ninth Circuit Court of Appeals filed May 29, 1992 (the "May 29th Opinion")[1] was not published. A copy of the May 29th Opinion is attached hereto as Appendix B. The Ninth Circuit Court of Appeals denied Petitioner's petition for rehearing and Respondent's suggestion for rehearing en banc by virtue of its Order filed July 28, 1992, a copy of which is attached hereto as Appendix A.

The May 29th Opinion reversed the earlier decision of the Ninth Circuit Court of Appeals filed March 25, 1991, which had unanimously reversed the decision of the United States District Court for the Central District of California entered May 3, 1989. A copy of the Ninth Circuit's March 25, 1991, Memorandum decision is attached hereto as Appendix C. The District Court had affirmed the decision of the United States Bankruptcy Court for the Central District of California entered January 5, 1988. The District Court did not write an opinion. A copy of the District Court's Order is attached hereto as Appendix D. The Bankruptcy Court's Findings of Fact and Conclusions of Law are attached hereto as Appendix E, and the Bankruptcy Court's Order is attached hereto as Appendix F.

STATEMENT OF JURISDICTION

This Court has jurisdiction pursuant to 28 U.S.C. §1254(1) to review the final decision of the Ninth Circuit Court of Appeals.

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[1] The May 29th Opinion was issued upon rehearing and replaced the Memorandum Opinion of the Ninth Circuit Court of Appeals filed March 25, 1991, a copy of which is attached hereto as Appendix B.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

A. United States Constitution, Article I, Section 8, Clause 4:

The Congress shall have power . . .

To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.

B. 11 U.S.C. §105. Power of court.

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

C. 11 U.S.C. §502. Allowance of claims or interests.

(a) A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.

(b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—

(1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured; . . . .

STATEMENT OF THE CASE

A. Factual Background.

The Hongkong and Shanghai Banking Corporation and Central Bank (the "Respondents" or the "Banks") are the holders of a claim against Moses N. Aslan (the "Petitioner" or the "Debtor") based on allegations made in a complaint filed by the Banks on or about December 2, 1983, which alleged numerous causes of action against several defendants, including the Debtor. The thrust of the allegations was directed to an alleged check kiting scheme. The complaint further alleged actual damages in the principal sum of $3,151,158.22, plus interest.

At the time, the Debtor owned several parcels of real property in the City of Los Angeles having an aggregate value in the millions of dollars (the "Parcels"). Having alleged a cause of action in the complaint for imposition of a constructive trust against the Parcels, the Banks recorded lis pendens upon all of the Parcels. In addition, with respect to at least one of the Parcels, commonly known as the Rowan Building, located in downtown Los Angeles, the Banks also held a promissory note secured by a first deed of trust and had commenced foreclosure proceedings in or around December 1984.

As a result of the lis pendens and the pending foreclosure proceedings, the Debtor was under extreme financial pressure to resolve his dispute with the Banks. Indeed, the lis pendens upon the Parcels made it virtually impossible for him to remedy his financial affairs without first satisfying the Banks. Accordingly, the Debtor was forced to enter into settlement negotiations with the Banks.

On or about March 25, 1985—the morning of the pending foreclosure sale of the Rowan Building—the parties and their counsel met on the steps of the Los Angeles Superior Court in Norwalk, California, in a final effort to settle their litigation. The Debtor and the Banks reached an agreement that day, and that agreement was subsequently memorialized in the Stipulated Judgment.

The Stipulated Judgment provided for entry of a judgment in the sum of $8,373,298.50, plus interest, but also provided that if the Debtor paid certain installment payments timely, which payments totaled $6,363,298.56, the Banks would provide the Debtor with an executed Satisfaction of Judgment.[2]

The Stipulated Judgment called for installment payments to be made by the Debtor totaling the aforesaid $6,373,298.56 as follows:

(1) $1,584,574.64 on July 1, 1985;
(2) $1,584,574.64 on September 30, 1985;
(3) $1,619,574.64 on December 31, 1985;
(4) The remaining unpaid balance plus interest on June 30, 1986.

The Stipulated Judgment did not specifically

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[2] It should be noted that the Stipulated Judgment contains no admission by the Debtor of liability for any alleged wrongdoing. Indeed, the entire record below is totally silent on this point. The Banks have taken every opportunity in the courts below to denigrate the Debtor's character and cast him in as bad a light as possible. However, neither the Stipulated Judgment nor the Bankruptcy Court's Findings of Fact contain any support whatsoever for such allegations. The Debtor's motivation for agreeing to the terms of the Stipulated Judgment is clear. By recording lis pendens and threatening foreclosure, the Banks had so tied up the Debtor's property that he had no choice but to agree to the Stipulated Judgment or face the loss of *all* his real estate holdings.

characterize the component sums of the Stipulated Judgment. The Debtor asserted that the difference between the Stipulated Judgment sum and the sum which would satisfy the Stipulated Judgment if paid timely, $2 million, was intended to be a penalty to be assessed against the Debtor if he failed to meet his obligations under the Stipulated Judgment. This conclusion is supported by various statements made by the Bank's counsel which were reflected in the record below.

On or about June 11, 1985, after continuing the foreclosure sale from time to time, the Banks foreclosed upon the Rowan Building, and were the successful bidders at the foreclosure sale, credit bidding the sum of $1,694,010.66, the amount due under the Banks' note and deed of trust thereon. A few weeks later, in July 1985, the Banks sold the Rowan Building to the Rowan Development Corporation (a buyer found by the Debtor) for $5 million.

Shortly thereafter, the Debtor and the Banks entered into a Letter Agreement dated August 1, 1985, pursuant to which the Banks agreed to, and did, credit the net proceeds of the Rowan Building sale to the full and complete payment of the July 1, 1985, and September 30, 1985, installment payments (each in the sum of $1,584,574.64) as required under the Stipulated Judgment.

At that point, a third party, the Amana Corporation, began negotiating with the Banks to purchase the Stipulated Judgment, which would have relieved Debtor from his liability to the Banks, including exposure on the $2 million penalty. At all times, the representative of the Amana Corporation made it clear to the Banks that, in purchasing the Stipulated Judgment, the Amana Corporation was effectively paying it off *current* and, therefore, the $2 million penalty could not be triggered and would not be a part of the purchase price.

On December 30, 1985, the Amana Corporation

submitted a letter (the "Letter of Intent") to the Banks in which the Amana Corporation offered to purchase the Stipulated Judgment for $3,536,110.90, an amount which did not include payment of the $2 million penalty. It was clearly understood by all the parties that the Amana Corporation's offer was to purchase the Stipulated Judgment without payment of the $2 million penalty.

The Banks responded to the Letter of Intent offer in the form of a counteroffer. The original purchase price proposed by the Amana Corporation of $3,536,110.90 in the Letter of Intent, which *did not include any penalty provision*, was retained in the Banks' counterproposal. The Banks' counteroffer was thereafter rejected by Amana Corporation, not because of the price, but because the Banks added certain indemnification provisions which were unacceptable to the Amana Corporation.

During the period from December 30, 1985, until February 28, 1986, negotiations continued between the Amana Corporation and the Banks toward a mutually acceptable purchase of the Stipulated Judgment. Eventually the negotiations broke down and the Debtor, at that point, had no choice but to file his Chapter 11 petition. The Chapter 11 case was commenced on March 3, 1986.

B. Procedural Background.

A Chapter 11 Trustee was appointed on June 23, 1986.

The Banks filed their Amended Proof of Claim (Secured) (the "Claim") on or about July 28, 1986.

The Debtor filed his objection to the Claim on November 24, 1986. The objection was originally scheduled to be heard on January 22, 1987, but was continued from time to time until August 13, 1987.

At the August 13, 1987, hearing, the Bankruptcy Court declined to inquire into the basis for the Stipulated Judgment to determine whether the $2 million provision

constituted an unenforceable penalty under either California or bankruptcy law. The Court considered the Stipulated Judgment final, binding, and nonreviewable.

At the continued hearing on September 2, 1987, the Bankruptcy Court allowed the Banks' Claim in the full amount of the Stipulated Judgment, plus accrued interest, totaling in excess of $8.3 million. The Bankruptcy Court reasoned that the Stipulated Judgment was so structured that the $2 million provision constituted an "option" whereby if the Debtor timely performed, the $2 million provision could be avoided. The Bankruptcy Court ruled that, under bankruptcy law, the time to exercise the "option" (make the fourth payment) expired on July 1, 1986, pursuant to 11 U.S.C. §108(b). The Bankruptcy Court found that since the Debtor had not made the fourth payment before that date (due to the ongoing negotiations between the Banks and the Amana Corporation), the Debtor had defaulted, the option had expired, and the entire amount of the Stipulated Judgment was due.

The Chapter 11 Trustee has paid to the Banks the full amount of their Claim as allowed by the Bankruptcy Court. The Banks have therefore been paid the $2 million plus interest at issue here.

After the hearing on the Debtor's objection to the Claim, both the Debtor and the Banks lodged proposed findings of fact and conclusions of law. Due to the internal inconsistencies in each and the Debtor's objection to the Banks' proposed findings, the Bankruptcy Court's order allowing the Banks' Claim was not entered until January 5, 1988. On January 22, 1988, the Debtor filed his motion for reconsideration of the Bankruptcy Court's order allowing the Banks' Claim and to amend the conclusions of law. The motion for reconsideration was withdrawn by the Debtor prior to the time set for hearing thereon. The Bankruptcy Judge's conclusions of law were amended, but not in a manner relevant to this appeal.

The Debtor thereafter timely filed his notice of appeal to the Bankruptcy Appellate Panel of the Ninth Circuit. The Banks cross-appealed on an issue involving the proper allocation of an offset. The offset issue is not a part of this appeal.

The Banks objected to the appeals being heard and decided by the Bankruptcy Appellate Panel of the Ninth Circuit, and the appeals were referred to the United States District Court for the Central District of California.

After briefing by the parties, the District Court, by Judge Edward Rafeedie, affirmed the Bankruptcy Court on both the Debtor's appeal and the Banks' cross-appeal. The Debtor thereupon filed his notice of appeal to the United States Court of Appeals for the Ninth Circuit and the Banks' notice of appeal followed.

The Ninth Circuit originally entered a Memorandum Opinion filed March 25, 1991, reversing the Bankruptcy Court's decision with regard to the $2 million penalty and affirming the Bankruptcy Court's decision with regard to the offset. The Banks requested a rehearing. On rehearing, the Ninth Circuit issued a second Memorandum Opinion filed May 29, 1992, which affirmed the Bankruptcy Court on both issues. The Debtor requested a rehearing and the Banks filed a suggestion for rehearing en banc. Both rehearing requests were denied by Order of the Ninth Circuit Court of Appeals on May 29, 1992.

C. Basis of Jurisdiction in the Bankruptcy Court.

The basis for federal jurisdiction of this case in the United States Bankruptcy Court is pursuant to 28 U.S.C. §1334(a) and 28 U.S.C. §157(b). The issue of the allowance of the Banks' Claim was a core proceeding under 28 U.S.C. §§157(b)(2)(B) and (C).

ARGUMENT

I.

REASONS FOR GRANTING THE WRIT

Petitioner's petition for writ of certiorari should be granted because the United States Court of Appeals for the Ninth Circuit has so sanctioned the Bankruptcy Court's departure from the accepted and usual course of judicial proceedings as to call for an exercise of the Supreme Court's power of supervision.

II.

THE BANKRUPTCY COURT'S MECHANICAL APPLICATION OF THE DOCTRINE OF RES JUDICATA AND 28 U.S.C §1738 TO A STIPULATED JUDGMENT RENDERED IN THE STATE COURT IGNORED THE EQUITABLE POWERS OF THE BANKRUPTCY COURT TO ACHIEVE THE GOALS OF THE FEDERAL BANKRUPTCY SCHEME.

The Bankruptcy Court erred by not following its mandate to fairly and equitably distribute the assets of the estate. Instead, it mechanically applied the doctrine of res judicata notwithstanding that the result unfairly affected other parties in interest.

The power of the bankruptcy court stems from Article I of the United States Constitution, which grants to Congress the power "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const., Art. I, §8, cl. 4. Bankruptcy law is a paramount law which takes precedence over all state laws and proceedings. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 67 S.Ct. 237, 91 L.Ed. 162 (1946); *Kalb v. Feuerstein*, 308 U.S. 433, 60 S.Ct. 343,

84 L.Ed. 370 (1940). Federal statutes govern the proof and allowance of claims based on judgments. "In determining which judgments are provable and what objections may be made to their proof . . . , the bankruptcy court is defining and applying federal, not state, law." *Heiser v. Woodruff*, 327 U.S. 726, 732, 66 S.Ct. 853, 90 L.Ed. 970 (1946), *reh'g denied*, 328 U.S. 879, 66 S.Ct. 1335, 90 L.Ed. 1647 (1946).

Section 105(a) of the Bankruptcy Code, 11 U.S.C. §§101 *et seq.* (1988) (hereinafter the "Bankruptcy Code"), provides that "the bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. §105(a) (1988). For most purposes, bankruptcy courts are "essentially courts of equity and their proceedings inherently proceedings in equity." *Pepper v. Litton*, 308 U.S. 295, 304, 60 S.Ct. 238, 84 L.Ed. 281 (1939) (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 240, 54 S.Ct. 695, 78 L.Ed. 1230 (1934)); *see also Continental Ill. Nat'l. Bank v. Chicago, Rock Island and Pac. Ry. Co.*, 294 U.S. 648, 55 S.Ct. 595, 79 L.Ed. 1110 (1935). A bankruptcy court may exercise its equity powers to do justice and prevent an inequitable result, such as to set aside a fraudulent claim, even where that claim has been reduced to judgment. *Heiser v. Woodruff*, 327 U.S. at 732; *Pepper v. Litton*, 308 U.S. at 305-06.

It is clear that a bankruptcy court is required to look behind a state court judgment in determining whether to allow a claim based on that judgment when the state court that issued the judgment lacked jurisdiction over the parties or the subject matter and when the judgment was obtained by collusion of the parties or by fraud. *See Pepper v. Litton*, 308 U.S. at 306; *Heiser v. Woodruff*, 327 U.S. at 736; *Margolis v. Nazareth Fair Grounds & Farmers Mkt., Inc.*, 249 F.2d 221, 224 (2d Cir. 1957); *Kelleran v.*

Andrijevic, 825 F.2d 692, 694 (2d Cir. 1987), *cert. denied*, 484 U.S. 1007, 108 S.Ct. 701, 98 L.Ed. 2d 652 (1988). Other courts have allowed a state court judgment to be attacked in the bankruptcy court where the judgment is a product of duress, *Fazio v. Alan Sinton, Ltd. (In re Fazio)*, 41 Bankr. 865 (Bankr. E.D. Pa. 1984), or where the judgment amount exceeded an express limitation imposed by the Bankruptcy Code, *In re Bus Stop, Inc.*, 3 Bankr. 26 (Bankr. S.D. Fla. 1980).

Petitioners argue that this list of exceptions is not exclusive. The bankruptcy court, as a court of equity, should be able to look behind a state court judgment whenever equity requires such a review. *See Kelleran v. Andrijevic*, 825 F.2d at 697-98 (Blumenfeld, J., dissenting).

As this Court stated in *Pepper v. Litton*, "[i]n the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." *Pepper v. Litton*, 308 U.S. at 307-08.

> [A] bankruptcy court has full power to inquire into the validity of any claim asserted against the estate and to disallow it if it is ascertained to be without lawful existence. And the mere fact that a claim has been reduced to judgment does not prevent such an inquiry.

Id. at 305 (citation omitted). A bankruptcy court's equitable powers "have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." *Id.*

This Court has clearly established that the doctrine of res judicata is not to be mechanically applied in the context of bankruptcy. A state court judgment should not have

automatic res judicata effect; only a bankruptcy judge can decide whether a claim is allowable, and the judge may look behind the claim to determine its validity. *See* 3 Collier on Bankruptcy ¶502.02, at 502-22-34 n. 8 (15th ed. 1980).

Where the doctrine of res judicata is applied, it is not based upon a technical application of the doctrine,

> but upon the court's recognition that the equitable considerations underlying that doctrine require its application in the *absence* of compelling circumstances to the contrary. To the extent that *equitable principles require reexamination* by the bankruptcy court of the bases for the judgment where these bases have been or could have been previously adjudicated, the doctrine of res judicata is *inapplicable* in bankruptcy proceedings.

Margolis v. Nazareth Fair Grounds & Farmers Mkt., Inc., 249 F. 2d, at 224 (emphasis added).

In the case at bar, the Bankruptcy Court erred by mechanically applying the doctrine of res judicata, despite the Debtor's assertion that a portion of the judgment was invalid under California law. The Bankruptcy Court refused to look behind the judgment to determine whether the Claim should have been partially disallowed as invalid, ruling that res judicata prevented the Court from considering the question.

III.

IN DETERMINING THE VALIDITY AND EXISTENCE OF CLAIMS, THE BANKRUPTCY COURT SHOULD APPLY STATE SUBSTANTIVE LAW; IN DETERMINING WHETHER A CLAIM SHOULD BE ALLOWED, THE BANKRUPTCY COURT SHOULD APPLY FEDERAL BANKRUPTCY LAW.

In the claims objection context, the bankruptcy court must engage in a two-part analysis. First, the bankruptcy court must consider whether the claim is valid, and this determination involves a review of the applicable law that forms the basis for the claim. "What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law." *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. at 161. *See also Grogan v. Garner*, ___ U.S. ___, 111 S.Ct. 654, 657, 112 L.Ed. 2d 755 (1991); *Southwest Bank v. Parsons (In re Parsons)*, 124 Bankr. 818 (Bankr. S.D. Cal. 1991). But state law is applied only in determining whether the creditor holds a valid claim, not whether and in what amount the claim should be allowed. *See In re Bowers*, 16 Bankr. 298 (Bankr. D. Conn. 1981).

After the bankruptcy court has determined whether the claim is valid, it then "must administer and enforce the Bankruptcy [Code] as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles." *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. at 163. Thus, even if a claim is valid under state law, the bankruptcy court is required to

apply federal bankruptcy law and general equitable principles in determining whether the claim should be allowed and in what amount. *In re Spanish Trails Lanes, Inc.*, 16 Bankr. 304 (Bankr. D. Ariz. 1981).

The plain meaning of Section 502(b)(1) of the Bankruptcy Code makes this principle all the more obvious. The statute requires the bankruptcy court to determine the *amount* of each claim and to allow such claim in that amount *unless the claim is unenforceable under applicable law*. *See* 11 U.S.C. §502(b)(1) (1988). Thus, the bankruptcy court is under a statutory mandate to inquire into the validity of each claim to which an objection is made and to establish the allowed amount of that claim.

As was stated above, the bankruptcy court in the allowance of claims process should not be bound by any broad or rigid rule of res judicata. In particular, where the claim is based on a stipulated judgment, and not on any litigation of the merits of the claim, the judgment cannot be said to reflect any determination of the substantive rights of the parties. *See Margolis v. Nazareth Fair Grounds & Farmers Mkt., Inc.*, 249 F.2d at 221.

In *Margolis*, two claims were based on judgment notes issued by the debtor corporation which had been reduced to judgment in state court by confession. The debtor objected to the allowance of the creditors' claims. The bankruptcy referee disallowed the claims after determining that there was no legal basis for the claims and that the creditors, former directors of the debtor, had engaged in fraud in obtaining the judgments. *Id.* at 222-23. The creditors argued that the bankruptcy referee had no power to inquire into the validity of their claims since the claims had been reduced to judgment in the state court prior to the bankruptcy filing. *Id.* at 223. Relying on *Heiser v. Woodruff*, the creditors asserted that the doctrine of res judicata should have been applied by the referee and their

claims allowed. *Id.* at 224.

On appeal, the Second Circuit Court of Appeals affirmed the bankruptcy referee's disallowance of the claims. The Second Circuit Court noted that the claims in *Heiser v. Woodruff* had been fully litigated in the lower courts. In such a context, "failure to raise a defense when there was ample opportunity to do so . . . will also generally preclude the recognition of the defense in the bankruptcy court." *Id.* However, where the party is prevented from raising a defense or has had no opportunity to litigate the merits of the claim in another forum, there is no reason to bar that defense when it is asserted in the bankruptcy court. *Id.* at 224-25; *accord Spilman v. Harley*, 656 F.2d 224 (6th Cir. 1981) (where important issues not actually litigated in prior proceeding, collateral estoppel does not bar relitigation in bankruptcy court); *Hovermale v. Pigge (In re Pigge)*, 539 F.2d 369 (4th Cir. 1976) (only issues which have actually been litigated in state court are entitled to res judicata or collateral estoppel effect).

In the instant case, the Respondents' Claim is based on a Stipulated Judgment entered in state court after the Debtor defaulted on the payment of debt. Petitioner has asserted that a portion of the Claim should be disallowed because it is invalid under California law or bankruptcy law. The Bankruptcy Court did not look into the basis of the Stipulated Judgment to determine the validity of the Claim, instead mechanically applying res judicata.

Had the Bankruptcy Court looked behind the Stipulated Judgment, it would have discovered that the $2 million penalty portion of the Banks' Claim is unenforceable under either California or bankruptcy law. California law provides that stipulated judgments are regarded as contracts between the parties and must be construed as any other contract. *Milicevich v. Sacramento Medical Center*, 155

Cal. App. 3d 997, 1004 fn. 9, 202 Cal. Rptr. 484 (Cal. Ct. App. 1984); *Rappenecker v. Sea-Land Service, Inc.*, 93 Cal. App. 3d 256, 263, 155 Cal. Rptr. 516 (Cal. Ct. App. 1979); *Los Angeles City School District of Los Angeles County v. Landier Investment Co.*, 177 Cal. App. 2d 744, 750-51, 2 Cal. Rptr. 662 (Cal. Dist. Ct. App. 1960) (hereinafter *L.A. v. Landier*). It is well established that contractual provisions which violate state law are unenforceable. *See, e.g., Lewis & Queen v. N. M. Ball Sons*, 48 Cal. 2d 141, 308 P.2d 713 (Cal. 1957).

In California,

> liquidated damages not reasonably related to actual damages are unenforceable and void as penalties. An exception exists where damages cannot be readily ascertained [Cal. Civ. Code, . . . §1671 (West 1970)], but since damages for the withholding of money are easily determinable—i.e., interest at prevailing rates—penal provisions for mere delay in the payment of money are not ordinarily enforceable. [Cal. Civ. Code, §3302 (West 1970)]. Although provisions for liquidated damages for late payments can be characterized as provisions for alternative performance rather than penalties, . . . it is now clear that when such "late charges" bear no relation to actual damages for delay they are void.

Sybron Corp. v. Clark Hospital Supply Corp., 76 Cal. App. 3d 896, 900, 143 Cal Rptr. 306 (Cal. Ct. App. 1978) (citations omitted). *See also Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n*, 9 Cal. 3d 731, 108 Cal. Rptr. 845, 511 P.2d 1197 (Cal. 1973); *L.A. v. Landier*, 177 Cal. App. 2d at 752-53. Whether the $2 million "late charge" in the Stipulated Judgment was unenforceable as a penalty under California law was a factual determination that the Bankruptcy Court should have made after holding a full

hearing on the merits to determine the substantive rights of the parties.

The Debtor also asserted that the $2 million at issue constituted an unenforceable penalty under bankruptcy law. As a court of equity, bankruptcy courts have not traditionally allowed the penalty portion of a creditor's claim. *See Black v. Strand (In re Black Ranches, Inc.)*, 362 F.2d 8, 15-16 (8th Cir. 1966) (quoting *In re Tastyeast, Inc.*, 126 F.2d 879, 881 (3d Cir. 1942), *cert. denied*, 316 U.S. 696, 62 S.Ct. 1291, 86 L.Ed. 1766 (1942)). Where a liquidated damages provision is clearly meant to be more than compensatory, the courts have typically characterized it as a penalty. In applying the principles of the Bankruptcy Code, courts frequently hold penalties to be unenforceable and disallow that portion of a creditor's claim. *See, e.g., In re Klefstad*, 95 Bankr. 622, 625 (Bankr. W.D. Wis. 1988); *In re Oahu Cabinets, Ltd.*, 12 Bankr. 160, 165 (Bankr. D. Haw. 1981).

The Bankruptcy Court erroneously stated that Petitioner should have raised the invalidity claim at the state court level, even though stipulated judgments are not generally entitled to appellate review. *See Thompson v. Maxwell Land Grant & Ry. Co.*, 168 U.S. 451, 18 S.Ct. 121, 42 L.Ed. 539 (1897) (cited with approval in *Newport v. Hatton*, 195 Cal. 132, 231 P. 987, 990 (Cal. 1924)). *See also Hibernia Sav. & Loan Soc'y v. Waymire*, 152 Cal. 286, 92 P. 645 (Cal. 1907); *Erlanger v. Southern Pac. Ry. Co.*, 109 Cal. 395, 42 P. 31 (Cal. 1895). Further, the Bankruptcy Court declined to hear evidence regarding the Petitioner's assertions that the Stipulated Judgment was obtained by Respondents under conditions of duress. Contracts entered into under economic duress can be set aside and any payments made recovered. *See, e.g., Rowland v. Watson*, 4 Cal. App. 476, 88 P. 495 (Cal. Dist. Ct. App. 1906). The Bankruptcy Court erred by not

making any inquiry into the grounds for the Claim, and the Ninth Circuit Court of Appeals should not have affirmed, and thus condoned, the Bankruptcy Court's misapplication of the law.

IV.

THE STATE'S INTEREST IN HAVING ITS COURTS' DETERMINATIONS RECOGNIZED MUST BE BALANCED AGAINST THE BANKRUPTCY COURT'S INTEREST IN REACHING A JUST AND EQUITABLE RESULT.

The principle underlying the doctrine of res judicata is "the generally recognized public policy that there must be some end to litigation and that when one appears in court to present his case, is fully heard, and the contested issue is decided against him, he may not later renew the litigation in another court." *Heiser v. Woodruff*, 327 U.S. at 733 (quoting *Baldwin v. Traveling Men's Assn.*, 283 U.S. 522, 525-26, 51 S.Ct. 517, 75 L.Ed. 1244 (1931). "Res judicata thus encourages reliance on judicial decisions, bars vexatious litigation, and frees the courts to resolve other disputes." *Brown v. Felsen*, 442 U.S. 127, 131, 99 S.Ct. 2205, 60 L.Ed. 2d 767 (1979).

The states clearly have an interest in having their courts' determinations recognized, and res judicata advances that interest. The bankruptcy courts should give due consideration to the states' interests, but only where the state court established the substantive rights of the parties after both sides had a full opportunity to be heard and the incentive to raise their various claims and defenses. *See id.*; *Spilman v. Harvey*, 656 F.2d at 224; *Hovermale v. Pigge (In re Pigge)*, 539 F.2d at 369; *Margolis v. Nazareth Fair Grounds & Farmers Mkt., Inc.*, 249 F.2d at 221; *Goldsmith v. Harck (In re Harck)*, 70 Bankr. 118 (9th Cir. 1987).

Thus, the bankruptcy court's analysis, when presented with an objection to a claim based on a judgment, must involve an inquiry into whether the judgment was based on actual litigation. The parties must have been afforded a full opportunity to be heard and the incentive to raise all claims and defenses upon which the claim in bankruptcy is made.

In the case at bar, the substantive rights of the Petitioner have never been established in a forum where he had a full opportunity to be heard and the incentive to raise his defenses to the Claim. The judgment upon which Respondents' Claim is based is a Stipulated Judgment. Petitioner entered into the stipulation before bankruptcy was filed, and the circumstances surrounding the stipulation show that Petitioner's goal at the time was to delay foreclosure of his properties. The Stipulated Judgment was not appealable. The issue of the validity of the $2 million penalty has never been litigated, Petitioner has not been afforded an opportunity to be heard, and until the claim was presented in the bankruptcy proceeding, Petitioner had no incentive to litigate its validity. It is worth noting that the penalty itself did not become part of Respondents' Claim until *after* the bankruptcy case was filed, because the final payment was not due at the time of the commencement of the case.

The bankruptcy court has an interest in ensuring that an estate is administered in such a way as to "bring about a ratable distribution of assets among the bankrupt's creditors." *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. at 161. The purposes of the Bankruptcy Code include successful rehabilitation of debtors and treating all creditors in a fair and equitable manner. *In re Spanish Trails Lanes, Inc.*, 16 Bankr. at 307. The possible injurious effect on other creditors is one of the aspects of equity that the bankruptcy may consider in the claims

allowance process. *In re Beck Rumbaugh Associates, Inc.*, 114 Bankr. 418, 421 (E.D. Pa. 1990), *aff'd*, 841 F.2d 1120 (3d Cir. 1988).

Equality of distribution among the creditors is one of the themes of the federal bankruptcy scheme. *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219, 61 S.Ct. 904, 85 L.Ed. 1293 (1941). Disallowance of penalties advances that theme. The bankruptcy court has the power to enforce and implement such equitable considerations under Section 105 of the Bankruptcy Code, which grants the court broad powers to carry out the bankruptcy statutes. 11 U.S.C. §105(a) (1988).

CONCLUSION

The interest of the state in having its court's judgments recognized and the interest of the bankruptcy court in equitably distributing the estate's assets must be balanced whenever the bankruptcy court is faced with a claim based upon a state court judgment. Mechanical application of res judicata, especially where the judgment was not the result of actual litigation on the merits, does not provide the appropriate balance. Instead, the Bankruptcy Court should have looked into the merits of the Claim presented by Respondents before deciding whether to allow the Claim. The Bankruptcy Judge failed to correctly apply the law, and the Ninth Circuit Court of Appeals has affirmed this erroneous decision.

For the foregoing reasons, the petition for a writ of certiorari should be granted so that Petitioner can present his defense to the $2 million penalty portion of Respondents' Claim, which Petitioner asserts is invalid and unenforceable under California or bankruptcy law and should be disallowed.

Dated: _____, 1992

Respectfully submitted,

PULLIAM, GRAVES & FOGEL

By: _____
Illyssa I. Fogel
Attorneys for Petitioner,
Moses N. Aslan

APPENDIX A

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re: Moses N. Aslan, Debtor.	FILED JUL 28 1992 Cathy A. Catterson, Clerk U.S. Court of Appeals
The Hongkong and Shanghai Banking Corporation; Central Bank, Plaintiffs-Appellees v. Moses N. Aslan Defendant-Appellant	No. 89-55629 D.C. No. CV-88-4089-ER
The Hongkong and Shanghai Banking Corporation; Central Bank, Plaintiffs-Appellants, v. Moses N. Aslan, Defendant-Appellee.	No. 89-55702 D.C. No. CV-88-4089-ER ORDER

Before: REINHARDT, HALL, and RYMER,* Circuit Judges.

The panel has voted to deny appellant's petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

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* The Honorable Pamela Ann Rymer was drawn by lot on August 27, 1991, to replace the Honorable Edward D. Re, former Chief Judge of the United States Court of International Trade, who formerly sat by designation on this panel. Judge Re retired while the petitions for rehearing were pending.

APPENDIX B

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re: Moses N. Aslan, Debtor.	)	FILED MAY 29 1992 Cathy A. Catterson, Clerk U.S. Court of Appeals
The Hongkong and Shanghai Banking Corporation; Central Bank, Plaintiffs-Appellees v. Moses N. Aslan Defendant-Appellant	) No. 89-55629) D.C. No. CV-88-4089-ER	

The Hongkong and Shanghai Banking Corporation; Central Bank,	No. 89-55702
Plaintiffs-Appellants,	D.C. No. CV-88-4089-ER
v.	MEMORANDUM*
Moses N. Aslan,	
Defendant-Appellee.	

Appeal from the United States District Court
for the Central District of California
Edward Rafeedie, District Judge, Presiding

Argued and Submitted July 12, 1990
Pasadena, California

Before: REINHARDT, HALL, and REIMER,** Circuit Judges.

Moses N. Aslan appeals, and the Hongkong and Shanghai Banking Corporation and Central Bank ("the Banks") cross appeal, from a decision of the district court which affirmed a decision of the bankruptcy court that sustained in part, and overruled in part, Aslan's objections to an amended proof of claim filed by the Banks. We

* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3.

** The Honorable Pamela Ann Rymer was drawn by lot on August 27, 1991, to replace the Honorable Edward D. Re, former Chief Judge of the United States Court of International Trade, who formerly sat by designation on this panel. Judge Re retired while the petitions for rehearing were pending.

affirm.

I.

Stipulated judgments and consent decrees may be given collateral estoppel effect. *See California State Auto. Ass'n Inter-Ins. Bureau v. Superior Court*, 788 P.2d 1156, 1159 (Cal. 1990). A final judgment or order of a court cannot be reviewed or disrupted by another court in a separate, collateral proceeding unless the judgment was induced by a party's fraudulent conduct, *see Atlantic Richfield Co. v. Superior Court*, 124 Cal. Rptr. 63, 66 (Cal. App. 1975), the issuing court lacked jurisdiction, or the judgment is invalid on its face. *See Gonzales v. State*, 137 Cal. Rptr. 681, 687 (Cal. App. 1977).

None of these exceptions apply to this case. Aslan has neither challenged the jurisdiction of the state court that approved the stipulated judgment nor alleged that the judgment was induced by fraudulent statements or conduct. Aslan argues that the $8.3 million debt he owes to the Banks contains a $2 million late payment penalty that is unenforceable under California contract law. To the extent the judgment is defective on that score, it is not apparent *on the face of the judgment*; therefore, it cannot be a ground of collateral attack. The argument now raised by Aslan should have been raised in the state court prior to consenting to the stipulated judgment.

To determine whether the judgment imposes an impermissible penalty under California law, we would need to analyze all of the references in that judgment and review other evidence to determine whether the parties made the type of fair approximation of anticipated damages called for in *Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n*, 511 P.2d 1197 (Cal. 1973). Such an inquiry by a federal court at this juncture would entail a far more involved

inquiry into the validity of the stipulated judgment than is permitted by principles of res judicata and collateral estoppel.

The exception to collateral estoppel set out in *Brown v. Felsen*, 442 U.S. 127 (1979) that applies when a bankruptcy court must decide whether a judgment debt ordered by a state court is *dischargeable* in bankruptcy is not applicable to the case at hand. Here, the question is whether the $8.3 million debt imposed by the judgment is valid—not whether the debt can be discharged in bankruptcy.

Nor does *In re Comer*, 723 F.2d 737, 740 (9th Cir. 1984), which held that a bankruptcy court may look behind a state court judgment and entertain evidence extrinsic to the state court record if the evidence pertains to the *nature* of the debt sought to be discharged, permit the bankruptcy court to look behind the judgment in this case. In *Comer*, we concluded that *Brown* does not allow debtors to challenge the *amount* of their debts in bankruptcy proceedings, and we denied the debtor an opportunity to challenge the extent of his alimony and child support obligations. *Id.* Aslan is similarly asking the court to determine how much he owes the Banks under the terms of the stipulated judgment (whether he owes $6.3 million under paragraph 7 of the judgment or $8.3 million under paragraph 1). Bankruptcy courts may only look at the *nature* of debts to determine whether they are dischargeable, not the amount of the debtor. *Id.*

Even if what Aslan seeks may be characterized as an inquiry into the nature of his debt to the Banks—whether the $8.3 million debt is partly an impermissible penalty—this case would still not fall within the scope of *Comer*. The *Comer* exception to collateral estoppel only allows debtors to challenge the nature of a debt in bankruptcy if *dischargeability* of the debt is in issue. The issue in this case focuses on the *validity* of the Banks' $8.3 million

claim, not its dischargeability. This type of challenge can be properly raised only on direct appeal in the state courts and is, therefore, barred in the bankruptcy court. The district court correctly refused to look behind the judgment.

II.

The Banks contend that the letter agreement either expressly or impliedly conditioned the application of the Rowan Proceeds to the stipulated judgment amount on Aslan's forbearance from attacking the judgment and his payment of all sums due thereunder. In support of this contention, the Banks state that Aslan expressly ratified, approved and affirmed the judgment and, therefore, Aslan agreed not to attack the judgment. Since Aslan has attacked the judgment, the Banks assert, he has breached the Letter Agreement and the Banks need not perform.

As support for their assertion that the Letter Agreement contains an implied covenant not to sue or not to attack the judgment, the Banks cite *College Block v. Atlantic Richfield Co.*, 254 Cal. Rptr. 179 (Cal. App. 1988), and *Northridge Hosp. Found. v. Pic 'N' Save No. 9*, 232 Cal. Rptr. 329 (Cal. App. 1986). Although the cases cited stand for the propositions stated, they involve leases, and do not support the Banks' assertion that the Letter Agreement and the stipulated judgment contain implied covenants not to sue or not to attack the judgment.

In *College Block*, the California Court of Appeal found an implied covenant of continued operation of a gas station in the lease. The lease did not set a fixed rent, but rather fixed a minimum amount plus a percentage based on the amount of gas delivered. *See College Block*, 254 Cal. Rptr. at 182. Reading the agreement as a whole, the court found that "[a] covenant of continued operation can be implied into commercial leases containing percentage rental

provisions in order for the lessor to receive that for which the lessor has bargained." *Id.* at 182. Consequently, the court concluded that an implied covenant was necessary to effectuate the intent of the parties, and that "it [was] so obvious that the parties had no reason to state the covenant." *Id.*

Here, however, the Banks have presented no evidence that indicates that the parties intended to include a covenant not to sue or not to attack the judgment, nor have the Banks presented evidence that indicates that an implied covenant not to sue or not to attack the judgment is so obvious that it need not be stated or set forth.

In *Northridge*, the question presented was whether a lessee's failure to renew the master lease "would so injure the rights of the sublessee [that] there [must] be an implied contract that the sublessor will [do so]." 232 Cal. Rptr. at 337. The court found an implied contract because the sublease contained "an absolute option to renew." *Id.* at 335. In the present case, there is no underlying agreement from which a covenant can be implied. Although *Northridge* discusses the duty of one party to an agreement not to injure the rights of the other party to the agreement, the question arose in a different context. The rights that were threatened in *Northridge* arose out of an express clause of the agreement between the lessee and the sublessee and were not implied. In the present case, the rights that the Banks claim are being threatened, namely freedom from having a court interpret a contract, are not expressly stated in the agreements.

The Banks cite no cases, and we have discovered none, that hold that a contract contains an implied covenant not to sue or not to attack the contract. Furthermore, cases that recognize an express covenant not to attack or sue also recognize that some lawsuits are allowed, as long as they are brought in good faith and not to frustrate the purpose

of the agreement. In *Winchester Drive-In Theatre, Inc. v. Warner Bros. Pictures Dist. Corp.*, 358 F.2d 432 (2d Cir. 1966), the court concluded that even if an implied covenant not to attack or sue could be held to exist, such a covenant would bar only suits that sought to attack the merits of the original suit. "It cannot be held to apply to the separate of settlement of that suit." *Id.* at 436.

In this case, for the court to imply a covenant not to sue or not to attack the judgment would be to add a term that was neither originally intended nor expected by the parties. We have noted that "courts are loathe to impose limitations or restrictions upon the parties which are not expressly contained in their agreement or which do not arise by necessary implication." *Republic Pictures Corp. v. Rogers*, 213 F.2d 662, 665 (9th Cir. 1954). Hence, under those circumstances, we have concluded that we will not imply a covenant not to sue or not to attack the judgment.

The Banks also contend that Aslan has breached the agreement because he has failed fully to perform his obligations, and, therefore the Banks need not credit the Rowan Proceeds against the judgment. As previously noted, the Banks have been paid the full amount of the judgment, including interest, less the credit of the Rowan Proceeds. Therefore, the Banks' alternative contention that Aslan has breached the agreement by failing to perform is without merit. Hence, the district court was correct in ruling that Aslan did not breach the Letter Agreement, and that he is entitled to a credit of the Rowan Proceeds.
AFFIRMED.

Judge Reinhardt dissents from Part I.

APPENDIX C

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re: Moses N. Aslan, Debtor,	FILED MAR 25 1991 Cathy A. Catterson, Clerk U.S. Court of Appeals
The Hongkong and Shanghai Banking Corporation; Central Bank, Plaintiffs-Appellees, Cross-Appellant, v. Moses N. Aslan, Defendant-Appellant, Cross-Appellee.	Nos. 89-55629, 89-55702 D.C. No. CV88-4089-ER MEMORANDUM*

Before: REINHARDT and HALL, Circuit Judges, and

* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3.

RE,** Chief Judge.

Defendant-appellant, Moses N. Aslan, a debtor in bankruptcy, appeals, and plaintiffs-appellees, the Hongkong and Shanghai Banking Corporation and Central Bank, (the Banks) cross appeal, from a decision of the United States District Court for the Central District of California which affirmed a decision of the Bankruptcy Court that sustained in part, and overruled in part Aslan's objections to an amended proof of claim filed by the Banks.

Aslan, on appeal, contends that the bankruptcy court erred when it ruled that a $2,000,000 provision in a stipulated judgment entered into by the parties was valid, rather than an unenforceable penalty. The Banks, on their cross-appeal, contend that the bankruptcy court erred in ruling that Aslan did not breach a letter agreement entered into by the parties in August 1985 (the Letter Agreement) thereby losing the right to a credit of a portion of the proceeds from the resale of the Rowan Building (the Rowan Proceeds).

The questions presented by Aslan's appeal are whether the district court erred in declining to examine the terms of the stipulated judgment, and in ruling that the $2,000,000 provision was not a penalty. The question presented by the Banks' appeal is whether the district court erred in concluding that Aslan was entitled to a credit of the Rowan Proceeds.

We hold that the district court erred in ruling that the $2,000,000 provision was not a penalty. We also hold that the district court committed no error in deciding that Aslan is entitled to a credit of the Rowan Proceeds. Hence, the judgment of the district court is affirmed in part and reversed in part.

** The Honorable Edward D. Re, Chief Judge of the United States Court of International Trade, sitting by designation.

BACKGROUND

In April 1982, the Banks commenced an action against Moses N. Aslan in Los Angeles Superior Court for recovery of damages because of Aslan's alleged check kiting scheme. The Banks claimed actual damages of $3 million, punitive damages, treble damages under the Racketeer Influenced and Corrupt Organizations Act, and constructive trusts of property owned by Aslan which was allegedly purchased with the proceeds of the check kiting scheme. Based upon their claim, the Banks recorded notices of lis pendens against these properties.

In 1985, Aslan and the Banks executed a Stipulation for Entry of Judgment pursuant to settlement negotiations. Judgment was entered according to the stipulation in Los Angeles County Superior Court after a hearing before the court. During the hearing, Aslan testified that he was entering into the stipulation voluntarily, and that he was represented by counsel during the settlement negotiations.

Paragraph 1 of the stipulated judgment states that judgment shall be entered against Aslan for "the sum of $8,373,298.56, plus interest thereon at the rate of 10% per annum . . . from March 26, 1985." Notwithstanding the apparent clarity of the $8,373,298.56 amount stated in paragraph 1, paragraph 7 of the stipulated judgment expressly states:

> [p]rovided *the sum of $6,373,298.56*, plus interest thereon at 10% per annum . . . from March 26, 1985, is timely and promptly paid on or before the following dates, according to the following schedule, . . . and provided Aslan has not defaulted on any obligation or indebtedness secured by any of the Properties, the *payment of said sum shall constitute satisfaction of this Judgment*.

(emphasis added). The stipulated judgment also provided in paragraph 19 that "[i]n the event that Aslan fails to perform any of his obligations as set forth herein, plaintiffs may immediately enforce and execute upon this Judgment." The Banks may "recover the full Judgment amount and all interest thereon as set forth in paragraph 1. . . ."

In addition to the stipulated judgment, the Hongkong Bank held a first priority lien against one of Aslan's properties, known as the "Rowan Building." In the Letter Agreement, the parties agreed that, in exchange for Aslan's affirming, ratifying, and approving the terms of the stipulated judgment, the proceeds of the Bank's *resale* of the Rowan building would be applied to the amount due under the stipulated judgment.

The Hongkong Bank foreclosed on the Rowan Building lien in 1985. At the foreclosure sale, the Hongkong Bank acquired the building by successfully bidding the amount of the lien. The Hongkong Bank later resold the building at a profit.

On August 1, 1985, Aslan and the Banks entered into the Letter Agreement which stated that if Aslan ratifies, affirms, and approves all the terms in the stipulated judgment, the Banks will credit a portion of the Rowan Proceeds against the amount owing on the stipulated judgment.

On March 3, 1986, Aslan filed for bankruptcy in the Bankruptcy Court for the Central District of California. On July 28, 1986, the Banks filed an amended proof of claim and sought to recover the amounts due under the stipulated judgment. Aslan filed objections to the proof of claim on the grounds that the stipulated judgment included a $2,000,000 penalty, illegal under California law, and further, that the Banks failed to credit the Rowan Proceeds as provided in the Letter Agreement.

The bankruptcy court overruled Aslan's objection to the

$2,000,000 provision, holding that the stipulated judgment was final and not subject to modification, amendment, or reexamination. The bankruptcy court also concluded that the $2,000,000 provision did not constitute a penalty. Aslan's objection was sustained as the Rowan Proceeds, and the Banks credited the Rowan Proceeds against the stipulated judgment, as required by the Letter Agreement.

Aslan appealed to the district court the bankruptcy court's determination that the $2,000,000 provision was not a penalty, and the Banks cross-appealed the crediting of the Rowan Proceeds contending that Aslan's breach of the Letter Agreement discharged their obligations and constituted a forfeiture of the right to the credit. The district court affirmed.

The Banks have been paid $8,373,298.56, the full amount of the judgment, plus interest, less the credit of the Rowan Proceeds. On this appeal, contending that it is a penalty, Aslan seeks a refund of the $2,000,000, and the Banks seek payment in the amount of the Rowan Proceeds, which they contend is due them because of Aslan's breach of the letter agreement.

STANDARD OF REVIEW

Our review of the district court's affirmance of a bankruptcy court is substantially the same as our review of a district court. Conclusions of law are reviewed de novo, and findings of fact are reviewed under the "clearly erroneous" standard. *See* Fed. R. Civ. P. 52(a); *Ragsdale v. Haller*, 780 F.2d 794,795 (9th Cir. 1986).

DISCUSSION

I. Aslan's Appeal
   A. Res Judicata/Collateral Estoppel

In California, as elsewhere, consent agreements or stipulations to judgment may be res judicata for the claim presented. *See California State Automobile Ass'n Inter-Insurance Bureau v. Superior Court* 50 Cal 3d 658, 788 P.2d 1156, 268 Cal. Rptr. 284 (1990) (en banc); 18 C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure* § 4443 (1981). The rules of res judicata generally apply in bankruptcy proceedings as well as in other actions. *In re Comer*, 723 F.2d 737, 739 (9th Cir. 1984). Nevertheless, res judicata cannot interfere with a bankruptcy court's obligation to determine "the nature of a debt for purposes of dischargeability, if doing so would prohibit the bankruptcy court from exercising its exclusive jurisdiction to determine dischargeability." *Id.* at 740.

In the present case, Aslan asserts that the bankruptcy court is being asked to enforce a prior state court judgment that includes an illegal penalty. Such enforcement would violate the longstanding rule that bankruptcy courts will not enforce a penalty. *See In re Oahu Cabinets, Ltd.*, 12 B.R. 160, 165 (Bankr. D. Haw. 1981). In light of this long-standing rule, and because of the fact that bankruptcy courts possess broad equitable powers to distribute a debtor's estate fairly among all debtors, *see Pepper v. Litton*, 308 U.S. 295, 303-08 (1939), res judicata does not automatically bar Aslan's claim. Rather, in order to determine the "nature" of the debt, the bankruptcy court must examine the prior state court judgment and decide whether a portion of that judgment constitutes an illegal penalty. *See In re Comer*, 723 F.2d at 740. If it concludes that it does, the court need not give it preclusive effect.

B. Discount/Penalty Provision

Under California law, the language of the stipulated judgment is the appropriate starting point when deciding whether a contract provision provides for alternative performances or is an unenforceable penalty. The Califor-

nia code provides that "[t]he language of a contract is to govern its interpretation, if the language is clear and explicit. . . ." Cal. Civ. Code § 1638 (West 1985). In determining whether a provision is a penalty or an option, however, the court must also look beyond the actual language used by the parties. *See Sybron Corp. v. Clark Hosp. Supply Corp.*, 76 Cal. App. 3d 896, 902, 143 Cal. Rptr. 306, 309 (1978).

Leading authorities indicate that acceptance of the parties' language is often inappropriate. For example, the Restatement states that parties may, at times, "attempt to disguise a provision for a penalty by using language that purports to make payment of the amount an alternative performance . . . [or] purports to offer a discount for prompt performance. . . ." *Restatement (Second) of Contracts* § 356 comment c (1981). Professor Williston states that "[e]ven though what is in fact a penal sum be stated as an absolute debt, its [penal] character may, nevertheless, appear from the nature of the contract and surrounding circumstances." 5 S. Williston, *A Treatise on the Law of Contracts* § 782 (3d ed. 1961).

The terms of the stipulated judgment attempt to make the $8,373,298.56 amount appear to be the amount of the debt with the availability of a $2,000,000 discount if certain conditions are met. The Banks, on appeal, contend that the discount, and their promise to forbear from seeking title to certain of Aslan's properties, allow Aslan to decide if he would rather pay less at an earlier date and keep his properties, or pay the larger paragraph 1 amount and risk losing his properties. The stipulated judgment does not contain a date by which Aslan must pay the "total" amount of the judgment if he "elects" that alternative.

In *Garrett v. Coast and Southern Federal Savings and Loan Association*, 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973), the California Supreme Court stated that

"[t]he mere fact that an agreement may be construed, if in fact it can be, to vest in one party an option to perform in a manner which, if it were not so construed, would result in a penalty does not validate the agreement." *Id.* at 737, 511 P.2d at 1200, 108 Cal. Rptr. at 848. In the present case, Aslan cannot be said to have had a choice between equally desirable alternatives. Rather, the stipulated judgment "contemplat[es] but a single definite performance with an additional charge contingent on the breach of that performance. . . ." *Id.* at 738, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

Our conclusion is also supported by a decision of the California Court of Appeal. In *Chambreau v. Coughlan*, 263 Cal. App. 2d 712, 69 Cal. Rptr. 783 (1968), the plaintiff sued for $8,075. The parties entered into a stipulated judgment for $8,075 that provided that the claim would be satisfied if the defendants paid the plaintiff $5,500 according to a schedule. *See id.* at 713-14, 69 Cal. Rptr at 785. The plaintiffs sued to enforce the judgment when the defendants failed to adhere to the schedule. *See id.* The court concluded that when "'a penalty or a forfeiture is used merely to secure the payment of a debt, . . . the real thing intended by the agreement, . . . [the court] will relieve against such penalty or forfeiture. . . .'" *Id.* at 717, 69 Cal. Rptr. at 787 (quoting 2 J. Pomeroy, *A Treatise on Equity Jurisprudence* § 433 (5th ed. 1941)). *See* Cal. Civ. Code § 3275 (West 1970).

In the present case, as in *Chambreau*, the $2,000,000 was an amount intended to secure the payment of the debt. Since the true debt was for $6,373,298.56, plus interest, we hold that the $2,000,000 provision is an unenforceable penalty under California law.

II. The Bank's Cross-Appeal

The Banks contend that the letter agreement either expressly or impliedly conditioned the application of the

Rowan Proceeds to the stipulated judgment amount on Aslan's forbearance from attacking the judgment and his payment of all sums due thereunder. In support of this contention, the Banks state that Aslan expressly ratified, approved and affirmed the judgment and, therefore, Aslan agreed not to attack the judgment. Since Aslan has attacked the judgment, the Banks assert, he has breached the Letter Agreement and the Banks need not perform.

As support for their assertion that the letter agreement contains an implied covenant not to sue or not to attack the judgment, the Banks cite *College Block v. Atlantic Richfield Co.*, 206 Cal. App. 3d 1376, 254 Cal. Rptr. 179 (1988) and *Northridge Hospital Foundation v. Pic 'N' Save No. 9, Inc.*, 187 Cal. App. 3d 1088, 232 Cal. Rptr. 329 (1986). Although the cases cited stand for the propositions stated, they involve leases, and do not support the Banks' assertion that the Letter Agreement and the stipulated judgment contain implied covenants not to sue or not to attack the judgment.

In *College Block*, the California Court of Appeal found an implied covenant of continued operation of a gas station in the lease. The lease did not set a fixed rent, but rather fixed a minimum amount plus a percentage based on the amount of gas delivered. *See College Block* at 1379-80, 254 Cal. Rptr. at 182. Reading the agreement as a whole, the court found that "[a] covenant of continued operation can be implied into commercial leases containing percentage rental provisions in order for the lessor to receive that for which the lessor has bargained." *Id.* at 1380, 254 Cal. Rptr. at 182. Consequently, the court concluded that an implied covenant was necessary to effectuate the intent of the parties, and that "it [was] so obvious that the parties had no reason to state the covenant. . . ." *Id.*

Here, however, the Banks have presented no evidence that indicates that the parties intended to include a covenant

not to sue or not to attack the judgment, nor have the Banks presented evidence that indicates that an implied covenant not to sue or not to attack the judgment is so obvious that it need not be stated or set forth.

In *Northridge* the question presented was whether a lessee's failure to renew the master lease "would so injure the rights of the sublessee [that] there [must] be an implied contract that the sublessor will [do so]." 187 Cal. App. 3d at 1101, 232 Cal. Rptr. at 337. The court found an implied contract because the sublease contained "an absolute option to renew." *Id.* at 1098, 232 Cal. Rptr. at 335. In the present case, there is no underlying agreement from which a covenant can be implied. Although *Northridge* discusses the duty of one party to an agreement not to injure the rights of the other party to the agreement, the question arose in a different context. The rights that were threatened in *Northridge* arose out of an express clause of the agreement between the lessee and the sublessee and were not implied. In the present case, the rights that the Banks claim are being threatened, namely freedom from having a court interpret a contract, are not expressly stated in the agreements.

The Banks cite no cases, and we have discovered none, that hold that a contract contains an implied covenant not to sue or not to attack the contract. Furthermore, cases that recognize an express covenant not to attack or sue also recognize that some lawsuits are allowed, as long as they are brought in good faith and not to frustrate the purpose of the agreement. In *Winchester Drive-In Theatre, Inc. v. Warner Bros. Pictures Distributing Corp.*, 358 F.2d 432 (2d Cir. 1966), the court concluded that even if an implied covenant not to attack or sue could be held to exist, such a covenant would bar only suits that sought to attack the merits of the original suit. "It cannot be held to apply to the separate issue of settlement of that suit." *Id.* at 436.

In this case, for the court to imply a covenant not to sue or not to attack the judgment would be to add a term that was neither originally intended not expected by the parties. We have noted that "courts are loathe to impose limitations or restrictions upon the parties which are not expressly contained in their agreement or which do not arise by necessary implication. . . ." *Republic Pictures Corp. v. Rogers*, 213 F.2d 662, 665 (9th Cir. 1954). Hence, under these circumstances, we have concluded that we will not imply a covenant not to sue or not to attack the judgment.

The Banks also contend that Aslan has breached the agreement because he has failed fully to perform his obligations, and, therefore, the Banks need not credit the Rowan Proceeds against the judgment. As previously noted, the Banks have been paid the full amount of the judgment, including interest, less the credit of the Rowan Proceeds. Therefore, the Banks' alternative contention that Aslan has breached the agreement by failing to perform is without merit. Hence, the district court was correct in ruling that Aslan did not breach the Letter Agreement, and that he is entitled to a credit of the Rowan Proceeds.

CONCLUSION

Since we hold that the Aslan is entitled to a refund of the $2,000,000 because it is an unenforceable penalty under California law, and a credit of $3,137,209.56 from the resale of the Rowan Building, the decision of the district court is

AFFIRMED in part and REVERSED in part.

APPENDIX D

CIVIL MINUTES—GENERAL

Case No. *CV88-4089190-ER* Date *May 1, 1989*

Title *Honkong, et al. -v- Moses N. Aslan*

DOCKET ENTRY

MAY -3 1989

PRESENT:

HON. *Edward Rafeedie*, Judge

Judy Matthews	*Julie Churchill*
Deputy Clerk	Court Reporter

ATTORNEYS PRESENT FOR PLAINTIFFS:

Peter C. Bronston

ATTORNEYS PRESENT FOR DEFENDANTS:

Martin J. Brill

PROCEEDINGS: Bankruptcy Appeal Oral Argument

Counsel present and this court affirms judgment of bankruptcy court.
(Ent. MAY 03 1989) J86

APPENDIX E

CHARLES M. LEVY
PETER C. BRONSON
KATHLEEN P. DORITY
LEVY & NORMINTON
A Partnership Of
Professional Corporations
815 Moraga Drive
Los Angeles, California 90049-1633
Telephone: (213) 471-3000

Attorneys for Creditor The Hongkong
and Shanghai Banking Corporation

ROY C. ZUKERMAN
MacKAY & ZUKERMAN
2525 Cherry Avenue
P.O. Box 22715
Long Beach, California 90801-5715
Telephone: (213) 595-4278

Attorneys for Creditor Central Bank

UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

In re	) Case No. LA 86-03637 GM
	)
MOSES N. ASLAN	) Chapter 11
	)
Debtor.	) FINDINGS OF FACT
	) AND CONCLUSIONS OF
	) LAW RE DEBTOR'S
	) OBJECTION TO FIRST
	) AMENDED PROOF OF
	) CLAIM FILED BY THE

) HONGKONG AND
) SHANGHAI BANKING
) CORPORATION AND
) CENTRAL BANK
)
)
) Date: September 2, 1987
) Time: 9:00 a.m.
) Place: Courtroom "G"
) 9th Floor

Hearings on the Objection ("Aslan's Objection") by debtor Moses N. Aslan ("Aslan") to the Amended Proof of Claim (the "Claim") filed by The Hongkong and Shanghai Banking Corporation ("Hongkong Bank") and Central Bank (collectively, the "Banks") were held on August 12, 1987 and September 2, 1987. At both hearings, Douglas D. Kappler of Robinson, Diamant, Brill & Klausner appeared on behalf of Aslan; at the September 2 hearing, Gary E. Klausner of the same firm also appeared for Aslan. At both hearings, Roy C. Zukerman of MacKay & Zukerman appeared for Central Bank, and Charles M. Levy, Peter C. Bronson and Kathleen P. Dority of Levy & Norminton, a Partnership of Professional Corporations, appeared for Hongkong Bank.

The Court has considered the records and pleadings on file in this case, the memoranda, declarations and other documents filed in support of and in opposition to Aslan's Objection, the evidence presented at the aforesaid hearings, and the arguments of counsel at the hearings.

GOOD CAUSE APPEARING, the Court hereby makes the following findings of fact and conclusions of law:

FINDINGS OF FACT

1. Aslan, an individual, is the debtor in this bankruptcy case.

2. The Banks are secured creditors of Aslan.

3. Aslan and the Banks are parties to a Stipulation For Entry of Judgment (the "Stipulation") executed in June, 1985. The Stipulation provided for entry of judgment against Aslan and in favor of the Banks.

4. Aslan was represented by counsel at all times during the negotiation and execution of the Stipulation.

5. Judgment (the "Judgment") in accordance with the Stipulation was entered July 18, 1985 in the Los Angeles County Superior Court, following a hearing at which Aslan testified concerning, among other things, the voluntariness of the Stipulation, and during which he was represented by counsel.

6. The Judgment, among other things, awarded damages in favor of the Banks against Aslan in the sum of $8,373,298.56 plus interest thereon at the rate of 10% per annum from March 26, 1985; and stated that Aslan holds legal title to each and all of the parcels of real property (the "Properties") enumerated in the Judgment for the use and benefit of the Banks. (The Banks had recorded Notices of Lis Pendens [the "Lis Pendens Notices"] against the Properties in or about April 1982.) The Judgment further provided that Aslan could reduce the amount due the Banks from $8,373,298.56 to $6,373,298.56 by making specified time payments, including a payment of $1,619,574.64 on December 31, 1985 (the "Third Payment"), and the sum of $1,584,574.64 plus all accrued and unpaid interest on June 30, 1986 (the "Fourth Payment").

7. Aslan never appealed from, or sought modification of or any relief from, the Judgment.

8. Aslan and the Banks entered into a Letter Agree-

ment (the "Letter Agreement") on or about August 1, 1985, by the terms of which, among other things, Aslan ratified, affirmed and approved all the terms and provisions of the Judgment; Aslan agreed to indemnify the Banks against various potential claims; and the Banks agreed to credit, against the Judgment, net proceeds of $3,137,-209.58 (including a $500,000 reserve for taxes), derived from the resale by Hongkong Bank of a building known as the Rowan Building, upon which Hongkong Bank had foreclosed. The Letter Agreement recited that no partial satisfaction of judgment need be filed with respect to the first $3,000,000 (the "Indemnity Fund") in principal reductions of the Judgment until, among other things, the Banks had been paid in full all amounts due under the Judgment and there was no possibility that the Banks would need to resort to the Indemnity Fund.

9. Aslan did not receive less than reasonably equivalent value for the consideration given by him pursuant to the Stipulation.

10. Between approximately December, 1985 and February, 1986, the Banks negotiated with Nassim H. Mussry ("Mussry") concerning the possible sale of the Judgement to Mussry. Mussry executed a Letter of Intent (the "Letter of Intent") dated December 30, 1985, in which, among other things, he signified his intention to purchase the Judgment, and agreed to indemnify the Banks against claims arising from the sale of the Judgment and from the sale or resale of the Rowan Building. The Letter of Intent also recited that if the Banks determined that they and Mussry would be unable to reach an agreement for sale of the Judgment, then Aslan would have, from that point, five days within which to make the Third Payment. Mussry paid a deposit of $2,000,000 pursuant to the Letter of Intent.

11. The Banks and Mussry failed to reach an agreement for sale of the Judgment to Mussry.

12. On February 20, 1986, the Banks' counsel notified Mussry in writing that, to the extent the Letter of Intent created any binding agreement, the Banks rescinded the Letter of Intent. The Banks returned Mussry's $2,000,000 deposit concurrently with that notification.

13. Also on February 20, 1986, the Banks' counsel notified Aslan in writing that the Letter of Intent had been rescinded, but offered to recommend to the Banks, notwithstanding the rescission, that if Aslan made the Third Payment within five days, *i.e.*, on or before February 25, 1986, the payment would be treated as timely.

14. Aslan filed his Chapter 11 petition herein on March 3, 1986. He had not made the Third Payment, and still has not done so.

15. The Fourth Payment was due on or before June 30, 1986. Aslan failed to make the Fourth Payment, timely or at all.

16. Neither the confirmed Trustee's Amended Plan of Reorganization nor any of the reorganization plans submitted by Aslan in this case purported to cure, under Bankruptcy Code Sections 1123 and 1124 or otherwise, any payment default by Aslan under the Judgment. (The Court has not found or concluded that such cure could have been effected in this case under those Sections.)

17. Aslan has not cured any default under the Judgment that could have been cured by making the Third Payment and Fourth Payment, or either of them.

18. To the extent that any of the foregoing findings of fact may be construed as a conclusion of law, it is hereby deemed to be a conclusion of law.

CONCLUSIONS OF LAW

19. To the extent that any of the following conclusions of law may be construed to be a finding of fact, it is

hereby deemed to be a finding of fact.

20. The liens created by the Judgment, in favor of the Banks, relate back to the recording of the Lis Pendens Notices.

21. Neither the Stipulation nor the Judgment constituted a fraudulent transfer.

22. The Judgment is final, and this Court will not modify, amend, abrogate or re-examine the Judgment.

23. The Judgement does not contain or involve any unenforceable penalty or forfeiture.

24. By virtue of the Letter Agreement, Aslan ratified, affirmed and approved all the terms and provisions of the Judgment, and his doing so comprised consideration for the Banks' agreement to credit $3,137,209.58 against the Judgment as aforesaid. As a result, this Court will not modify, amend, abrogate or re-examine the Judgment.

25. Section 362 of the Bankruptcy Code did not toll the time for Aslan to make the Fourth Payment. Section 108(b) of the Bankruptcy Code governed any right of Aslan to reduce the Judgment amount by making such payment.

26. Aslan failed to timely reduce the total Judgment amount from $8,373,298.56 to $6,373,298.56 by making the Fourth Payment within the time prescribed by Bankruptcy Code Section 108(b).

27. Aslan's Objection, to the extent it seeks to reduce the principal amount of the Claim by $2,000,000, is without merit by reason of Aslan's failure to make the Fourth Payment within the time prescribed by Bankruptcy Code Section 108(b).

28. Aslan's Objection as to the aforesaid $2,000,000 is overruled.

29. Aslan's Objection is sustained in part, in that he is entitled to a credit, against the full Judgment amount of $8,373,298.56 plus interest, in the sum of $3,137,209.58, plus interest thereon at 10 percent per annum from and after the date Hongkong Bank received the proceeds from

its resale of the Rowan Building, at such time as (and only to the extent that) the Trustee has determined that such sums will not be needed for payment of any of the actual or potential claims against which the Letter Agreement indemnifies the Banks.

THE HONORABLE GERALDINE MUND
United States Bankruptcy Judge

PRESENTED BY:

ROY C. ZUKERMAN
MacKAY & ZUKERMAN

CHARLES M. LEVY
PETER C. BRONSON
KATHLEEN P. DORITY
LEVY & NORMINTON
A Partnership Of Professional Corporations

By Peter C. Bronson
Attorneys for Creditors Central Bank
and The Hongkong and Shanghai Banking
Corporation, respectively

APPROVED AS TO FORM

MARTIN J. BRILL
DOUGLAS D. KAPPLER
ROBINSON, DIAMANT, BRILL & KLAUSNER

By Martin J. Brill
Attorneys for Debtor Moses N. Aslan

APPENDIX F

CHARLES M. LEVY
PETER C. BRONSON
KATHLEEN P. DORITY
LEVY & NORMINTON
A Partnership Of
Professional Corporations
815 Moraga Drive
Los Angeles, California 90049-1633
Telephone: (213) 471-3000

Attorneys for Creditor The Hongkong
and Shanghai Banking Corporation

ROY C. ZUKERMAN
MacKAY & ZUKERMAN
2525 Cherry Avenue
P.O. Box 22715
Long Beach, California 90801-5715
Telephone: (213) 595-4278

Attorneys for Creditor Central Bank

UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

In re	) Case No. LA 86-03637 GM
	)
MOSES N. ASLAN	) Chapter 11
	)
Debtor.	) ORDER ON DEBTOR'S
	) OBJECTION TO FIRST
	) AMENDED PROOF OF
	) CLAIM FILED BY THE
	) HONGKONG AND
	) SHANGHAI BANKING

) CORPORATION AND
) CENTRAL BANK
)
) Date: September 2, 1987
) Time: 9:00 a.m.
) Place: Courtroom "G"
_____) 9th Floor

Hearings on the Objection ("Aslan's Objection") by debtor Moses N. Aslan ("Aslan") to the Amended Proof of Claim (the "Claim") filed by The Hongkong and Shanghai Banking Corporation ("Hongkong Bank") and Central Bank (collectively, the "Banks") were held on August 13, 1987 and September 2, 1987. At both hearings, Douglas D. Kappler of Robinson, Diamant, Brill & Klausner appeared on behalf of Aslan; at the September hearing, Gary E. Klausner of the same firm also appeared for Central Bank, and Charles M. Levy, Peter C. Bronson and Kathleen P. Dority of Levy & Norminton, a Partnership of Professional Corporations, appeared for Hongkong Bank.

The Court has considered the records and pleadings on file in this case, the memoranda, declarations and other documents filed in support of and in opposition to Aslan's Objection, the evidence presented at the aforesaid hearings, and the arguments of counsel at the hearings. Based on separate Findings of Fact and Conclusions of Law issued by this Court, and good cause otherwise appearing,

IT IS HEREBY ORDERED that:

1. Aslan's Objection, to the extent it seeks to reduce the principal amount of the Claim by $2,000,000, is overruled.

2. Aslan's Objection is sustained in part, in that he is entitled to a credit of $3,137,209.58, plus interest thereon at 10 percent per annum from and after the date Hongkong Bank received the proceeds from its resale of the building known as the Rowan Building, against the $8,373,298.56

plus interest which is the full amount of the Judgment entered in favor of the Banks and against Aslan on July 18, 1985 in the Los Angeles County Superior Court, at such time as (and only to the extent that) the Trustee has determined that such sums will not be needed for payment of any of the actual or potential claims against which the Letter Agreement dated August 1, 1985 between Aslan and the Banks indemnifies the Banks.

/s/
THE HONORABLE GERALDINE MUND
United States Bankruptcy Judge

PRESENTED BY:

ROY C. ZUKERMAN
MacKAY & ZUKERMAN

CHARLES M. LEVY
PETER C. BRONSON
KATHLEEN P. DORITY
LEVY & NORMINTON
A Partnership Of
Professional Corporations

By /s/
Peter C. Bronson
Attorneys for Creditors Central Bank
and The Hongkong and Shanghai Banking
Corporation, respectively

APPROVED AS TO FORM:

MARTIN J. BRILL
DOUGLAS D. KAPPLER
ROBINSON, DIAMANT, BRILL & KLAUSNER

By /s/
Martin J. Brill
Attorneys for Debtor Moses N. Aslan

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